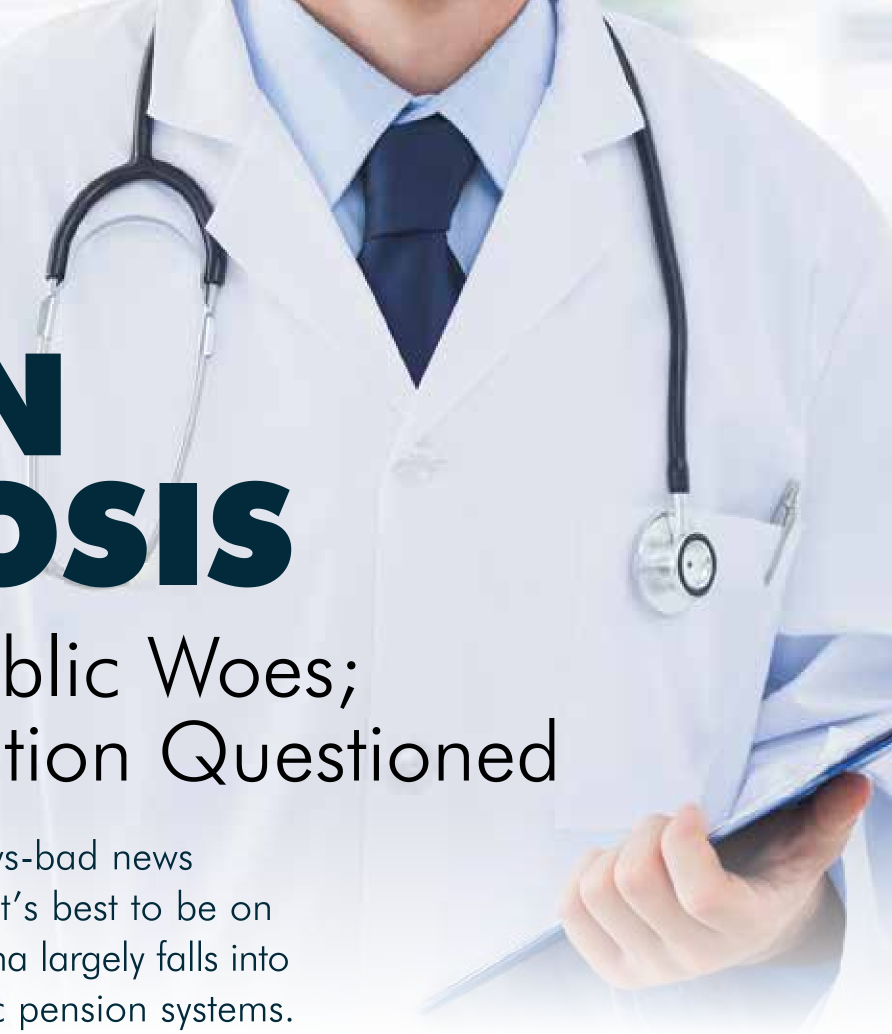

FEATURE STORY

By Tom Schuman

PENSION PROGNOSIS

Indiana Avoids Public Woes; Employee Preparation Questioned

When someone presents a good news-bad news scenario, it goes without saying that it's best to be on the "good" side of the equation. Indiana largely falls into that category when the topic is public pension systems.

The bad news: States owe $757 billion (according to the Pew Center on the States in a 2013 report; others place the number much higher) in unfunded pension liabilities. That doesn't count local pensions, which Pew estimates at another $99 billion.

Yes, Indiana contributes to that shortfall but at a much lower rate than most other states. Mary Beth Braitman, a partner at Indianapolis-based law firm Ice Miller, terms Indiana's "funded status" percentages in the chart on Page 31 (we'll explain that more a little later) as "remarkable."

But pension questions and challenges persist, both for private sector employers and employees – no matter where they work – who are not enough doing enough to adequately prepare for their retirement years.

"De-risking," hybrid plans, and automatic enrollment and escalation are a few of the concepts in today's pension and retirement playbook. Is your organization adjusting to changing times? Are individuals in financial jeopardy?

Sizing up the problem

Andrew Biggs, a resident scholar at the American Enterprise Institute (AEI), has an extensive background in state and local government pensions as well as Social Security reform. He uses a popular card game to illustrate why pension challenges are so much more prevalent in recent years.

"Imagine if you put $100 down and you're playing blackjack. That's not a huge amount of money on the table and it's not a game that's incredibly risky. That's how you might see pensions in the 1970s or early 1980s," he offers. "Since that time, both the amount of money put on the table and the amount of risk they're investing in has increased. It's three times bigger today than the 1970s. In the 1970s, it was bonds and fixed income stocks; now, it's stocks and increasingly private equity hedge funds, real estate."

Biggs explains further in a recent economic perspectives article for AEI.

Why the tripling? In the 1950s, there were more than seven active government employees for each retiree or pension beneficiary. Today, that ratio is 1.75 and continuing to drop.

Why riskier? The yields on Treasury bonds were between 5.5% and 6.5% from 1975 to 1995. Today, it's 0.1% – and prior to the financial crisis, the yields were barely above 3%. Thus, it takes more risk to earn the historically assumed investment returns of around 8%.

Biggs says that some believe a 6.5% expected return might be more appropriate today. "If you want an expected return of 8% today, you have to take much more risk than 20 years ago. You tell that to people in pensions, and it just doesn't register with them. They think because we're the government and

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He grades Indiana's public pension systems as "being in better shape than most" due to a modest benefit and more conservatively run system.

Braitman has extensive knowledge of the government pension systems in Indiana and other states.

"Indiana is in remarkable shape," she observes. "Even with one of the most conservative investment return assumptions (6.75% compared to the approximate 8% norm), we're near the top in funded status. The 92.3% total funded status (of the Indiana system with the exception of the Teachers' Retirement Fund prior to 1996) if we had a 7.5% assumption is astronomical; the 85.3% using the current 6.75% assumption is still very, very good."

Indiana Public Retirement System

The state has a conservative investment return assumption but high levels of funded status compared to most plans.

(dollars in millions)	Current Assumption (6.75%)		If 0.75% Increase (7.5%)	
Three Largest Accounts	Unfunded Actuarial Accrued Liability	Funded Status	Unfunded Actuarial Accrued Liability	Funded Status
PERF	$3,198.4	80.2%	$2,154.8	85.7%
TRF – 1996 Account	$295.5	93.8%	($124.3)	102.9%
1977 Fund	$212.2	95.2%	($249.1)	106.3%
Total*	$3,811.6	85.3%	$1,835.9	92.3%

- PERF – Public Employees' Retirement Fund
- TRF – Teachers' Retirement Fund
- 1977 Fund – 1977 Police Officers' and Firefighters' Pension and Disability Fund

Source: Indiana Public Retirement System   *Excluding pre-1996 TRF and several smaller accounts

Indiana innovation

While many states today are looking at plans that combine defined benefits (traditional pensions) and defined contributions – most commonly 401(k) type programs – the Indiana system has included those elements for nearly 60 years. All general employees and teachers hired after 1955 are covered. The state contributes to the defined benefit portion, with employees contributing no less than 3% to a separate annuity savings account.

"There's already a hybrid nature of our system here," Braitman explains. She adds that the states that had incorporated employee contributions previously had it count toward the defined benefit portion of the plan. "Ours is split to where you have the value separately calculated on the ultimate balance in your annuity savings contract – and that provides an additional income.

"In a way, it's splitting the risk. The investment risk throughout your working career on the formula benefit is the employer's (state government). On the employee contribution account, the risk is the employee's."

Braitman calls the Indiana system "innovative in its fundamental design of risk sharing from its inception." She cites the lack of volatility required to fund the plan and the foresight of legislators in understanding its importance. "It has served the state and the public employees well."

State shifts

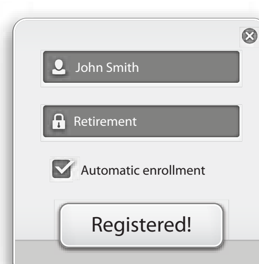
Before the Great Recession of 2008-2009, only two states (Alaska and Michigan – just for teachers) required new state employee hires to participate solely in a defined contribution plan. Indiana was joined by Oregon in its required hybrid approach, according to the Center for Retirement Research at Boston College, while six states offered the defined contribution portion as an option.

Since then, mandatory hybrid plans have been introduced in several more states with others discussing defined contribution options. One of the primary reasons for the changes is the staggering unfunded liabilities.

Still, statistics show that defined benefit

Defined Contribution Plans – 2013

PLANSPONSOR magazine surveyed more than 5,300 retirement plan sponsors from a broad variety of U.S. industries. A few of the results:



Automatic enrollment
Yes – 40.8%
No – 52.9%

Participation rate for eligible employees
Average – 76.9%

Confidence that your employees will reach retirement income goals by age 65
Somewhat – 32.5%
Only a little – 28.6%
Not at all – 20.4%
Confident – 9%

Default deferral as percentage of employee's salary
3% – 47%
2% – 11%
4% – 10%

Auto escalation
Yes – 26.9%
No – 62.3%

Potential Change for ASAs

The Indiana Public Retirement System (INPRS) plans to privatize the annuity savings accounts (ASAs) described in this story, but the Indiana General Assembly may put that move on hold.

Current law allows retiring state workers to reinvest ASAs and earn an annual 7.5% return on the amount they invest. Under privatization, those payouts are expected to decrease to around 4%. The proposed change has generated substantial opposition among state and local employees.

In December 2013, the INPRS alerted lawmakers to the plan. Representative Woody Burton (R-Greenfield) authored legislation that would block that effort for five years. Its fate will be determined as the session winds down to a March 14 closure.

plans are offered by about 90% of state and local governments. (In the private sector, the opposite is true with less than 20% of workers in 2010 covered by just a traditional pension plan – chart below).

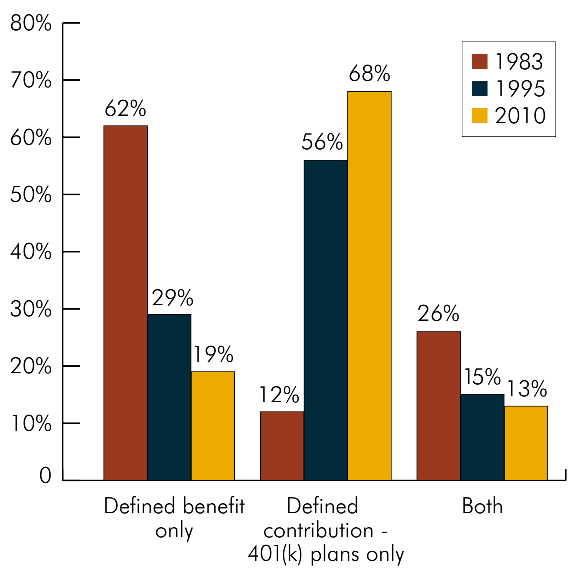
Andy Wilkinson is vice president and managing principal for actuarial and employee benefits consulting firm McCready and Keene, a OneAmerica Financial Partners company. He says the traditionally less stringent public sector accounting rules are changing. "It will only put a bigger spotlight on the plans that are underfunded. I don't think it will impact plans that are well funded, like Indiana's."

Risky business

The government moves to incorporate defined contribution elements are part of shifting responsibilities from taxpayers to the state employees. In the private sector, it's making that same shift from employers to employees. Marc Sciscoe, a partner with Braitman at Ice Miller who specializes in private sector work, terms it "de-risking."

"Employers don't (and often can't) risk the big fluctuations, the hit to their financial statements because of interest rate changes and changes in the market," he details. "It has been dramatic because for 15 years we've had artificially low interest rates and that makes the amount put away for many of these defined benefited obligations less valuable. So a lot of employers are going out and de-risking by buying annuities, offering lump-sum options to try and mitigate those fluctuations. If you move to defined contribution, you've completely achieved de-risking."

Workers With Pension Coverage By Type of Plan
(1983, 1995 and 2010)



Sources: Center for Retirement Research of Boston College

Biggs believes there are far fewer defined contribution plans in the public sector because of the strength of public employee unions.

On the private sector side, Biggs is a big defined contribution (DC) fan, offering responses to his own statements about potential shortcomings.

"DC plans are voluntary, not enough people participate (make it mandatory or have automatic enrollment, he says); people don't know what to choose for investments (make a better default investment choice); people don't reallocate their money over their lifetime (have a life cycle fund that handles that). The DC world has problems, but they're solvable problems and they seem to be trying to solve them."

Savings shortfall

The Pension Protection Act of 2006 included a provision for automatic enrollment – employees are enrolled in their organization's 401(k) plan unless they specifically opt out. Since then, automatic escalation has also become a fixture for some.

"Every study I've seen has surprised me at how successful automatic enrollment is," Sciscoe asserts. "With automatic increases, if an employer gives raises in March, for example, the amount you contribute to your 401(k), absent an election not to do so, will go up (typically)1%. Very frequently those will go until it reaches an 8% or 10% employee contribution. That has also been very successful."

In 2013, Prudential Retirement noted that its plans that include automatic enrollment have a 90% participation rate compared to 62% for plans without that feature. Yet, the same report cites a 2011 survey that identifies only 44% of plans overall offer automatic enrollment with fewer than that including auto escalation.

The concern is if individuals are saving enough.

"Employees are in for a very rude awakening; it's frightening to me," Sciscoe attests. "Somebody who's making $40,000 a year and sees an account balance of $250,000 might think that's a lot, but if you convert that to a monthly benefit, you'll be shocked at how little that will provide. Particularly when you couple that with what health care costs in retirement. I don't really see how you can separate the two."

Wilkinson says McCready and Keene is unveiling a tool this year – a three-month retirement tryout to raise awareness.

"There are a lot more people who are retiring today who don't have a defined benefit plan. They're looking at their account balance and realizing they can't afford to retire or they're working part time," he shares. "An account balance really isn't helping in getting people's minds around how that translates into a weekly check. Over time, the industry and employers are waking up to the fact that we're not saving enough for retirement. Anything we can do to help improve that savings rate is a good thing."

Sciscoe says employers are concerned but limited in what they can do from a financial standpoint. They continue to offer education tools, but employees must be willing to take advantage.

Wilkinson touts the auto enrollment and escalation as people "have to be saving enough for the investment piece to really matter."

And while the private sector world continues the move toward defined contributions, Wilkinson isn't ready to give up on defined benefits.

"I still think DBs are a viable plan. They have received bad press in the public sector, but it's not necessarily the design of the plan that is wrong but more the implementation and the commitment – or lack of commitment – in some levels to funding. We're bullish on DB plans."

RESOURCES: Andrew Biggs, American Enterprise Institute, at www.aei.org | Mary Beth Braitman and Marc Sciscoe, Ice Miller, at www.icemiller.com | Andy Wilkinson, McCready and Keene, at www.mcak.net/mcak